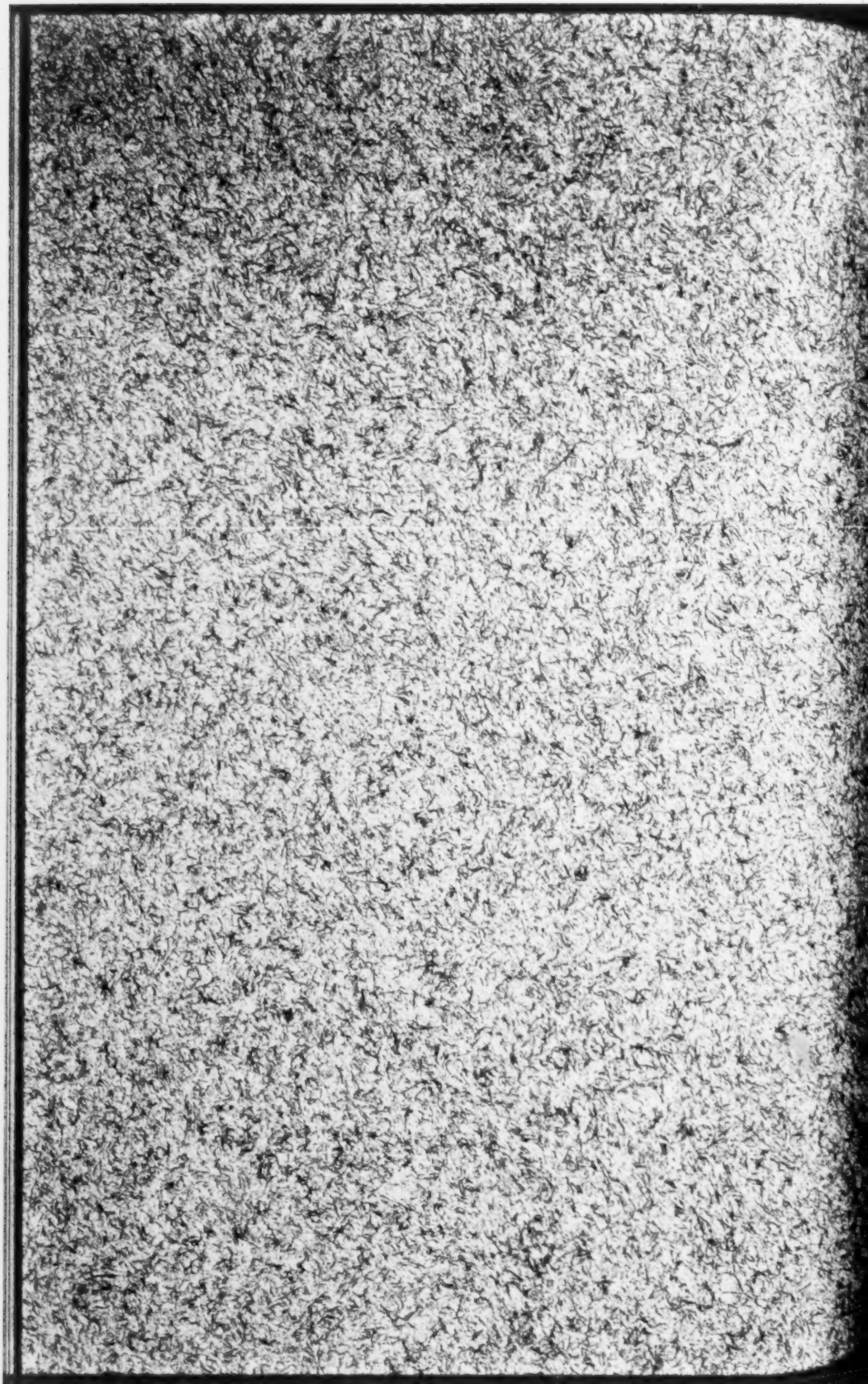

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 1

In the Matter of HACKETT, HOFF & THIES-[illegible] INC., Bankrupt.

MARINE NATIONAL EXCHANGE BANK OF MILWAUKEE and WEST SIDE BANK,

Petitioners,

vs.

[illegible] ZIMMERS MANUFACTURING COM-[illegible] and M. H. GROSSMAN, Trustee in Bankruptcy,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONERS

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1934

No. 148

In the Matter of HACKETT, HOFF & THIERMANN, INC., Bankrupt.

MARINE NATIONAL EXCHANGE BANK OF MILWAUKEE and WEST SIDE BANK,

Petitioners,

v.

KALT-ZIMMERS MANUFACTURING COMPANY and M. H. GROSSMAN, Trustee in Bankruptcy,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONERS

OPINIONS OF THE COURTS BELOW

The opinion of the United States District Court for the Eastern District of Wisconsin is reported in 6 Fed. Supp. 638 (R. 77-79).

The opinion of the United States Circuit Court of Appeals for the Seventh Circuit was rendered on April 18, 1934, and is reported in 70 F. (2d) 815 (R. 95-102).

JURISDICTION

The date of the judgment of the Circuit Court of Appeals to be reviewed is April 18, 1934, (R. 103). The petition for a writ of certiorari was filed July 3, 1934, and was granted on October 8, 1934.

The statutory provision which, it is believed, sustains the jurisdiction of this Court is Section 240 of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938.

Bearer bonds of respondent, Kalt-Zimmers Manufacturing Company, were executed, issued, and pledged to petitioners in Wisconsin (R. 9, 33-37, 53, 28, 31). The Circuit Court of Appeals for the Seventh Circuit was required to determine whether under the laws of the State of Wisconsin said bonds were negotiable instruments and whether petitioners were holders thereof in due course. Said Circuit Court of Appeals construed and applied Section 116.61, Wisconsin Statutes of 1929, directly contrary to the prior interpretation and application of said section by the Supreme Court of Wisconsin, contrary to the construction of the same section of the Uniform Negotiable Instruments Law by the Circuit Court of Appeals of the 2nd Circuit, and contrary to the weight of authority on this important question (R. 96-102).

The cases sustaining said jurisdiction are:

Burns Mortgage Company, Inc. v. Fried, — U. S. —, 78 L.Ed. (Adv. Op.) 939, 54 Sup. Ct. 813.

Forsyth v. Hammond, 166 U. S. 506, 514.

QUESTIONS PRESENTED

Whether the Federal Courts in construing transactions in Wisconsin involving the Wisconsin (*Uniform*) Negotiable Instruments Law must follow the construction of said law by the Wisconsin Supreme Court.

Whether the Circuit Court of Appeals erred in holding that the recitals in these negotiable bearer bonds, in which the pledgor was named the trustee of the security, were alone a sufficient basis for the determination that the pledgees took said bonds in bad faith within the meaning of the Wisconsin Negotiable Instruments Law.

STATEMENT OF THE CASE

Petitioners separately petitioned the Referee in Bankruptcy in the matter of Hackett, Hoff & Thiermann, Inc., bankrupt, for authority to sell collateral pledged for value by the bankrupt to petitioners respectively, namely, certain bearer bonds of the face amount of Fourteen Thousand Five Hundred Dollars ($14,500) executed and issued at Milwaukee, Wisconsin, by respondent, Kalt-Zimmers Manufacturing Company, a Wisconsin corporation (R. 5, 15).

Respondent, Kalt-Zimmers Manufacturing Company, intervened, answered the petitions, and filed cross-petitions (R. 8, 19). It alleged that the bankrupt, as trustee of the trust indenture securing the bonds, had pledged the bonds for the bankrupt's individual indebtedness, that such bonds had been issued without consideration and that petitioners were not *bona fide* holders thereof (R. 8-11, 19-22).

Petitioners respectively answered the cross-petitions alleging that the bonds were negotiable and that they were *bona fide* holders thereof for value (R. 12, 22).

The issues between said respondent and each of petitioners were heard and determined together by stipulation (R. 25).

On October 9, 1929, respondent executed a trust deed, as of August 15, 1929, issued thereunder bearer bonds of the total amount of One Hundred Fifteen Thousand Dollars ($115,000), and delivered the same to said Hackett, Hoff & Thiermann, Inc., for the purpose of authentication and sale (R. 9, 33-37, 53).

Said trust deed provided that said bonds should be duly certified, and negotiated and sold by the trustee, and further, that the trustee should first set aside sufficient bonds, or the proceeds of sufficient bonds, to pay off the underlying first mortgage, which was originally Fifty-five Thousand Dollars ($55,000), and on which there was then an unpaid balance of Thirty-five Thousand Dollars ($35,000) (R. 34-35). Said trust deed further provided that after so setting aside said bonds, or the proceeds thereof, the balance of the proceeds should be paid out in liquidation of the cost of the contemplated building, which was then in course of construction, and that any balance, then remaining, should be at the disposal of said Kalt-Zimmers Manufacturing Company (R. 35). Said trust deed further provided that the trustee, or any of its officers, agents or stockholders, might acquire, own and deal in said refunding bonds with the same rights as if not trustee thereunder, and would not be obligated to account to anyone for any profits made thereby (R. 37).

On June 8, 1931, when said Hackett, Hoff & Thiermann, Inc., was adjudicated a bankrupt, there were outstanding and unpaid first mortgage bonds, secured by the underlying mortgage, of the face amount of Twenty-five

Thousand Dollars ($25,000) (R. 44); on June 8, 1931, the bankrupt held in its possession refunding bonds of the face amount of Six Thousand Five Hundred Dollars ($6,500), and there were pledged to sundry banks, including petitioners, refunding bonds of the face amount of Eighteen Thousand Five Hundred Dollars ($18,500) (R. 44-46).

The refunding bonds provided:

> "Kalt-Zimmers Manufacturing Company of Milwaukee, Wisconsin, * * * a corporation duly organized and existing under and by virtue of the laws of the State of Wisconsin, acknowledges itself to be indebted, and for value received, hereby promises to pay to the bearer hereof, or if this bond is registered, then to the registered holder hereof, the sum of $500 * * * *" (R. 66).

Said bonds also contain the following recital:

> "Said bonds are issued under and secured by a mortgage or deed of trust of even date herewith, duly made, acknowledged and delivered by said Kalt-Zimmers Manufacturing Company to Hackett, Hoff & Thiermann, Incorporated, Trustee, to which deed of trust reference is hereby made with the same effect as though recited at length herein, for the description of the property mortgaged, the nature and extent of the security, the rights of the holders of the bonds, and the terms and conditions upon which the said bonds are issued, held and secured, and may, before their fixed maturities, be declared at once due and payable, and the manner of prepayment before maturity." (R. 67).

The bankrupt from time to time borrowed large sums of money from petitioners, and, as security for said loans, pledged sundry bonds (R. 27-33). Among the bonds so pledged were certain of said refunding bonds of respond-

ent; in some instances said refunding bonds were substituted for other bonds previously pledged, and in other instances said bonds were pledged at the time of the making of loans (R. 27-33). The banks, in accepting the pledges of said Kalt-Zimmers Manufacturing Company refunding bonds, gave value therefor, and took the same in the usual course of business (R. 29, 31).

It was established that it was the general practice and custom in the City of Milwaukee for banks to loan money to bond houses, which also acted as trustees under trust mortgages, and to receive as collateral bonds purchased by such houses (R. 54, 55).

The primary issues between respondent and each of the petitioners were whether said bonds were negotiable instruments and whether petitioners were holders thereof in due course without notice of any defect in the title to said bonds within the meaning of Section 116.61, Wisconsin Statutes of 1929 (part of Negotiable Instruments Law), reading as follows:

> "*Actual knowledge of infirmity necessary to notice.* To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith."

The Supreme Court of the State of Wisconsin in *Pollard v. Tobin,* 211 Wis. 405 (1933), had construed and applied this section of the statutes in a case involving identical issues. Under substantially identical facts, that court in the case cited held bonds of identical form and terms to be negotiable, and the pledgee bank to be a *bona fide* holder without notice of any defect in the title of the pledgor to said bonds.

The Referee in Bankruptcy reached the same conclusion as the Supreme Court of the State of Wisconsin (R. 69-72). He entered an order denying the cross-petitions and authorizing the sale of said bonds by the pledgee banks under their pledge agreements (R. 72).

The District Court of the United States for the Eastern District of Wisconsin on a petition for review, filed by respondent, reversed this order of the Referee primarily on the ground that petitioners had constructive notice of the alleged defect in the pledgor's title to said bonds, and directed the return of the record to the Referee in Bankruptcy for further proceedings (R. 77-80).

On petitioners' appeal, the Circuit Court of Appeals for the Seventh Circuit affirmed the order of the District Court on April 18, 1934 (R. 95-103).

Petitioners at the argument before the Circuit Court of Appeals with its consent filed the printed case (record) in *Pollard v. Tobin,* 211 Wis. 405. Petitioners have filed with the clerk of this Court a certified copy of such printed case in the event that the Court desires to examine the same.

The Circuit Court of Appeals in its opinion states in respect of the decision of the Wisconsin Supreme Court in *Pollard v. Tobin,* 211 Wis. 405:

> "Appellants urge that this ruling contravenes a recent decision of the Supreme Court of Wisconsin, *Pollard v. Tobin,* — Wis. —, 247 N.W. 453. That decision involved the identical question now under consideration, arising out of a transaction between the same bankrupt and another bank, in which there were pledged under similar circumstances, bonds practically identical in form and terms with the bonds herein involved. There the court held that

the bonds were negotiable, and that the bank was a holder in due course, * * * ." (R. 97).

The Circuit Court of Appeals nevertheless refused to follow or accept the decision of the Wisconsin Supreme Court as binding in the interpretation and application of the Wisconsin Negotiable Instruments Law on the ground that it was not bound by a decision of a state court interpreting or applying a *uniform* law, such as the Negotiable Instruments Law (R. 100-101); because of the references in the bonds to the trust mortgage and to the pledgor as trustee of the security, said Circuit Court of Appeals charged petitioners with knowledge that the bonds themselves were held in trust and under such circumstances held that petitioners took said bonds in bad faith (R. 97-100).

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred —

1. In refusing to accept and follow the decision of the Supreme Court of Wisconsin in the case of *Pollard v. Tobin,* 211 Wis. 405, construing and applying the Negotiable Instruments Law of that state.

2. In holding that petitioners had notice of a defect in the pledgor's title to said Kalt-Zimmers Manufacturing Company bonds under the provisions of Section 116.61, Wisconsin Statutes of 1929 (part of the Uniform Negotiable Instruments Law).

SUMMARY OF ARGUMENT

I. The decision of the Circuit Court of Appeals construing and applying the Wisconsin Negotiable Instruments Law is directly in conflict with the latest decision

of the Supreme Court of the State of Wisconsin on the same matter, namely, *Pollard v. Tobin,* 211 Wis. 405. The Circuit Court of Appeals erred in refusing to accept and follow said decision of the Wisconsin Supreme Court on the ground that the federal courts were not bound by a state court's construction of its own *uniform* laws.

II. The Kalt-Zimmers Manufacturing Company bearer bonds are negotiable instruments under and governed by the Negotiable Instruments Law in force in Wisconsin at the time of the execution and delivery of said bonds. The negotiable character of said bonds is not destroyed by the reference therein to the trust deed securing payment of the same, for the statements contained in said bonds in respect of the trust deed refer solely to the security and to the rights of the holders of said bonds in and to such security.

Petitioners, as pledgees of said bonds, took the same in good faith and are holders in due course under the Wisconsin Negotiable Instruments Law. Under said law, bad faith alone and not constructive notice will defeat the rights of the holder of a negotiable instrument. Neither the reference to the trust deed nor the fact that the pledgor was named trustee of the security was notice to petitioners that the pledgor held the bonds themselves in a fiduciary capacity. The burden of proof was upon the respondent to establish bad faith on the part of petitioners in taking said bonds.

ARGUMENT

I.

THE DECISION OF THE CIRCUIT COURT OF APPEALS CONSTRUING AND APPLYING THE WISCONSIN NEGOTIABLE INSTRUMENTS LAW IS DIRECTLY IN CONFLICT WITH THE LATEST DECISION OF THE SUPREME COURT OF THE STATE OF WISCONSIN ON THE SAME MATTER, AND IS, THEREFORE, ERRONEOUS.

Neither the District Court for the Eastern District of Wisconsin, nor the Circuit Court of Appeals determined whether the Kalt-Zimmers Manufacturing Company bonds were negotiable. The Supreme Court of Wisconsin in *Pollard v. Tobin,* 211 Wis. 405 held identical bonds negotiable. The lower courts charged petitioners with constructive notice of the alleged trust capacity in which Hackett, Hoff & Thiermann, Inc., held said bonds. It is submitted that this conclusion as to constructive notice is erroneous. *There is no evidence in the instant case, in fact no claim has been made, that petitioners had actual knowledge of any trust capacity in which Hackett, Hoff & Thiermann, Inc., allegedly held said bonds.*

Section 116.61, Wisconsin Statutes of 1929, and the Wisconsin Supreme Court in construing the same, expressly declare that the rule of constructive notice is not law in Wisconsin.

It was decided as a matter of law in *Pollard v. Tobin* that the pledgee of corporate bearer bonds, identical in form and terms with those here involved, pledged by the trustee under the trust mortgage securing such bonds, did not have knowledge of such facts as to make the

taking one in bad faith. The bonds in *Pollard v. Tobin* contained the same references to the trust mortgage quoted above from the bonds here in controversy.

It is submitted that all of the questions involved in the instant case had been decided by the Supreme Court of Wisconsin in the Pollard case prior to the decisions in the lower courts, and should have been followed by the Circuit Court of Appeals.

The present situation is that the title of pledgees of similar bonds is held valid in the state courts of Wisconsin and invalid in the federal courts.

The federal courts are bound to follow the construction and application by the highest court of a state of state statutes such as the *Uniform* Negotiable Instruments Law.

> *Burns Mortgage Company, Inc. v. Fried,* — U.S. —, 78 L.Ed. (Adv. Op.) 939, 54 Sup. Ct. 813.

The Circuit Court of Appeals applied a contrary rule, relying on *Commercial National Bank v. Canal-Louisiana Bank,* 239 U. S. 520 (R. 100-101). But, it is submitted, such case does not declare the law to be as stated by said Circuit Court of Appeals.

In *Burns Mortgage Company, Inc. v. Fried,* the court states as follows:

> "Section 34 of the Judiciary Act of 1789 directs that the laws of the several states, except where the Constitution, treaties or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law in the courts of the United States, in cases where they apply. *The*

> *applicable state statute furnishes the rule of decision for a federal court sitting in the state or outside its borders. And in that court the law must be given the meaning and effect attributed to it by the highest court of the state, as if the state court's decision were literally incorporated into the enactment, whatever the federal tribunal's opinion as to the correctness of the state court's views.*"
>
> "And a declaratory act is no less an expression of the legislative will because the rule it prescribes is the same as that announced in prior decisions of the courts of the state. Nor is there a difference in this respect between a statute prescribing rules of commercial law and one concerned with some other subject of narrower scope." (Italics ours).

Section 34 of the Judiciary Act of 1789, referred to by the Court, reads as follows:

> "The laws of the several States, except where the Constitution, treaties, or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law, in the courts of the United States, in cases where they apply." (Act of September 24, 1789, 1 Stat. at L. 92, Chap. 20, par. 34, Rev. Stat. par. 721, U.S.C. title 28, par. 725)

It is respectfully submitted that the Circuit Court of Appeals erred in refusing to accept and follow the decision of the Wisconsin Supreme Court in *Pollard v. Tobin,* 211 Wis. 405.

II.

THE KALT-ZIMMERS MANUFACTURING COMPANY BONDS ARE NEGOTIABLE INSTRUMENTS UNDER THE UNIFORM NEGOTIABLE INSTRUMENTS LAW, IN FORCE IN WISCONSIN, AND PETITIONERS ARE HOLDERS IN DUE COURSE THEREOF.

A.

THE KALT-ZIMMERS MANUFACTURING COMPANY BONDS ARE NEGOTIABLE INSTRUMENTS.

The Circuit Court of Appeals refrained from deciding whether the bonds here in controversy are negotiable. Petitioners contend that the Kalt-Zimmers Manufacturing Company bonds are negotiable instruments. The Wisconsin Supreme Court's decision to that effect is *Pollard v. Tobin,* 211 Wis. 405. It is submitted that such is the law generally.

Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 1, 8.

Paepcke v. Paine, et al., 253 Mich. 636.

Pflueger v. Broadway Trust & Savings Bank, 351 Ill. 170.

Siebenhauer v. Bank of California Nat. Asso., 211 Cal. 239.

Pratt v. Higginson, et al., 230 Mass. 256.

Merchants National Bank v. Detroit Trust Co,. 258 Mich. 526.

Enoch v. Brandon, 249 N. Y. 263.

Bank of California v. National City Co., 138 Wash. 517.

Morris Canal & Banking Co. v. Fisher, 1 Stockton's Chancery, 667 (N.J.).

White v. Vt. & Mass. R. R. Co., 21 Howard 575.

Hotchkiss v. Nat. Shoe & Leather Bank, 21 Wall. 354.

Chavelle v. Washington Trust Co., 226 Fed. 400, 408.

Crittenden v. Widrevitz, 272 Fed. 871.

Sears v. Greater N. Y. Devel. Co., 51 F. (2d) 46.

Higgins v. Hocking Valley R. Co., 188 App. Div. 684.

Pittsburgh C. C. & St. L. Ry. Co. v. Lynde, 55 Ohio St. 23.

1. Said bonds are negotiable under the Negotiable Instruments Law in force in Wisconsin at the time of the execution and delivery of said bonds.

Section 116.02, Wisconsin Statutes of 1929, provides as follows:

> "An instrument to be negotiable must conform to the following requirements:
>
> (1) It must be in writing and signed by the maker or drawer.
>
> (2) Must contain an unconditional promise or order to pay a sum certain in money.
>
> (3) Must be payable on demand or at a fixed or determinable future time.
>
> (4) Must be payable to order or to bearer.
>
> (5) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty."

Said bonds, a copy of one of which is set forth at page 66 of the Record, provide as follows:

> "Kalt-Zimmers Manufacturing Company, of Milwaukee, Wisconsin, (hereinafter referred to as "first party"), a corporation duly organized and existing under and by virtue of the laws of the State of Wisconsin, acknowledges itself to be indebted, and for

value received, hereby promises to pay to the bearer hereof, or, if this bond is registered, then to the registered holder hereof, the sum of $500 in gold coin of the United States of America of the present standard of weight and fineness, without grace on the 15th day of August, A. D. 1939, and interest thereon from the 15th day of August, A. D. 1929, at the rate of six per cent (6%) per annum, * * * " (R. 66).

It is expressly provided in the bonds that they shall pass by delivery except in case of registration (R. 67).

Under similar statutory provisions, bonds of like character have been held negotiable in California, Illinois, Massachusetts, Michigan, New York, Tennessee and Washington.

Siebenhauer v. Bank of California Nat. Asso., 211 Cal. 239.

Pflueger v. Broadway Trust & Savings Bank, 351 Ill. 170.

Paepcke v. Paine, et al., 253 Mich. 636.

Pratt v. Higginson, et al., 230 Mass. 256, 258.

Merchants National Bank v. Detroit Trust Co., 258 Mich. 526.

Enoch v. Brandon, 249 N. Y. 263.

Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 1, 8.

Bank of California v. National City Co., 138 Wash. 517.

2. The negotiable character of said bonds is not destroyed by the reference therein to the trust deed securing payment of said bonds.

Pollard v. Tobin, 211 Wis. 405.

Mendelson v. Realty Mortgage Corporation, 257 Mich. 442.

Enoch v. Brandon, 249 N.Y. 263.

Pflueger v. Broadway Trust & Savings Bank, 351 Ill. 170.

Paepcke v. Paine, et al., 253 Mich. 636.

Merchants National Bank v. Detroit Trust Co., 258 Mich. 526.

a. Language in a bond which attempts to modify the obligations of, and rights under such bond by incorporation in it, through reference, of provisions of the trust deed, is strictly construed, and only such parts of the trust deed are therein incorporated as are expressly and specifically made a part of such bond.

Pollard v. Tobin, 211 Wis. 405.

Mendelson v. Realty Mortgage Corporation, 257 Mich. 442.

b. To destroy negotiability of a bond, the portions of the trust deed specifically incorporated into the bond must qualify or make uncertain or conditional the promise to pay. In *Enoch v. Brandon,* 249 N.Y. 263, the court stated:

> "If in the bond or note anything appears requiring reference to another document to determine whether in fact the *unconditional promise to pay a fixed sum at a future date is modified or subject to some contingency,* then *the promise is no longer unconditional.* What that document may provide is immaterial. *Reference to the paper itself said to be negotiable determines its character. Old Colony Trust Co. v. Stumpel,* 247 N.Y. 538; 161 N. E. 173 * * *
>
> "Do, then, the references in these particular bonds to the trust mortgage *modify the promise to pay;* do they subject it to *some possible condition or contingency* described elsewhere; or do they merely

> determine the rights and remedies of the holder under the mortgage? We must consider the instrument as a whole, *not wresting* any one phrase from its context and concentrating our attention upon it alone. Further, where the meaning is doubtful, we must adopt the construction most favorable to the bondholder." (Italics ours).

In *Pflueger v. Broadway Trust & Savings Bank,* 351 Ill. 170, the court in respect of such recitals said:

> "A recital in a promissory note or bond, or a reference in it to some other instrument, in order to destroy its negotiability must be of such a nature that the recital in the bond or the reference to the other instrument qualifies or makes uncertain or conditional the promise to pay."

The references to the trust deed in the Kalt-Zimmers Manufacturing Company bonds are the following:

> "Said bonds are issued under and secured by a mortgage or deed of trust of even date herewith, duly made, acknowledged and delivered by said Kalt-Zimmers Manufacturing Company to Hackett, Hoff & Thiermann, Incorporated, Trustee, to which deed of trust reference is hereby made with the same effect as though recited at length herein, for the description of the property mortgaged, the nature and extent of the security, the rights of the holders of the bonds, and the terms and conditions upon which the said bonds are issued, held and secured, and may, before their fixed maturities, be declared at once due and payable, and the manner of prepayment before maturity." (R. 67).

This provision in the bonds is not a general reference to the entire trust deed and all of its provisions. It is an express reference for certain stated purposes, to-wit: (1) the description of the *property mortgaged,* (2) the nature and extent of the security, (3) the rights of the

holders of the bonds, (4) and the terms and conditions upon which said bonds are issued, held and secured, (5) and may, before their fixed maturities, be declared at once due and payable, and the manner of prepayment before maturity. Under the rules above stated, the only provisions of the trust mortgage incorporated into these bonds by such reference are the provisions therein specifically mentioned.

It is clear that the provisions relating to the description of the property mortgaged, and the nature and extent of the security relate solely to the security and in no wise qualify or make uncertain or conditional the promise to pay the sum stated in said bonds at the time fixed.

Pollard v. Tobin, 211 Wis. 405.

The reference to "the rights of the holders of the bonds" relates only to the rights of such holders in and to the security. It has been universally so held.

Pollard v. Tobin, 211 Wis. 405.
Paepcke v. Paine, 253 Mich. 636.
Enoch v. Brandon, 249 N. Y. 263.

The recital "the terms and conditions upon which the said bonds are issued, held and secured" has been held not to destroy the negotiable character of the bonds. Such recital has been interpreted to be a reference only to the lien or security created by the trust deed and to the rights of the holders of said bonds in and to such lien or security. The following like references to trust deeds in bonds have been held not to destroy the negotiability of the bonds.

> "To which Trust Agreement reference is hereby made for a statement of the terms under which the said Debentures are issued."
>
> *Paepcke v. Paine,* 253 Mich. 636.

"And the terms and conditions upon which said bonds are issued and secured."

Enoch v. Brandon, 249 N. Y. 263.

"And the terms and conditions upon which said bonds are secured and are to be used."

Merchants National Bank v. Detroit Trust Co., 258 Mich. 526.

"To which trust agreement reference is hereby made for a statement of the terms under which the said debentures are issued and the rights and obligations of the company, of the trustee and of the respective holders of the said debentures under the said trust agreement."

Pflueger v. Broadway Trust & Savings Bank, 351 Ill. 170.

The Supreme Court of Wisconsin in the case of *Pollard v. Tobin,* held that such recitals did not destroy the negotiable character of a bond with identical language.

In respect of such recitals in bonds, the New York Court of Appeals in *Enoch v. Brandon,* 249 N.Y. 263, said:

"We hold that here there is no modification of the promise to pay, made in explicit terms. The provisions all have to do with the trust mortgage. They refer to the rights conferred by it upon the bondholders and limit and explain those rights. They are so linked together as to indicate that the obligor was speaking solely of the security. *A purchaser, scanning the bonds, would have the same thought.* It would never occur to him that, when November 1, 1941, arrived, because of something contained in the mortgage he might be unable to collect the amount due him. *He would interpret the statement that the bonds were secured by, and entitled to the benefits and subject to the provisions of, the mortgage, as meaning that a foreclosure or other relief*

might be had thereunder only subject to its provisions. He would see that reference to it is also made to determine the terms and conditions under which the bonds are issued and secured. Again, it would mean to him, as it means to us, that only by turning to the mortgage might he discover the precise nature of the lien he is to obtain. He would see that the bonds were to be issued, not only upon the general credit of the corporation, but upon the faith of some collateral mortgage. To it he must go, if further knowledge as to this security is desired." (Italics ours).

In *Pflueger v. Broadway Trust & Savings Bank,* 351 Ill. 170, the court in regard to the effect of such recitals in bonds used the following language:

> "If a prospective purchaser wanted to buy these debentures, he would, upon reading them, first find an unconditional promise to pay a sum certain of money to bearer at a fixed future time. The quoted reference to the trust agreement in the debenture does not affect this unconditional promise to pay, but only means that the holder is referred to the trust agreement for his rights under that agreement. This distinction between the unconditional promise to pay under the debenture and the reference to other rights of the holder under the trust agreement is clearly drawn by the Supreme Court of Michigan in *Paepcke v. Paine,* 253 Mich. 636, 235 N. W. 871, 873, 75 A.L.R. 1205, * * * ".

There can be no doubt but that said Kalt-Zimmers Manufacturing Company bonds are negotiable instruments; they are in the usual form of instruments of such character and were intended by the parties to be negotiable. Each bond contains an unconditional promise to pay to the bearer thereof the sum therein stated at the time fixed. In express terms it is provided that said bonds shall pass by delivery except in case of registration,

and in such event, it is expressly provided that the negotiability of the interest coupons by delivery should not be restrained (R. 67). All of the recitals in said bonds in respect of the trust deed refer solely to the security for the payment of the bonds and in no wise render the unconditional promise to pay uncertain or conditional. It is, therefore, respectfully submitted that said bonds must be held to be negotiable instruments.

B.

PETITIONERS ARE HOLDERS IN DUE COURSE OF SAID KALT-ZIMMERS MANUFACTURING COMPANY BONDS.

1. A pledgee may be a holder in due course.

Pollard v. Tobin, 211 Wis. 405.

Crittenden v. Widrevitz, 272 Fed. 871.

Pflueger v. Broadway Trust & Savings Bank, 351 Ill. 170.

Merchants National Bank v. Detroit Trust Company, 258 Mich. 526.

Brokaw v. Kunze, 127 Wash. 593.

In this case the petitioners either made new loans or surrendered other collateral to the pledgor in consideration of the pledge of the bonds (R. 29, 32). Such loans, or the release of previously pledged collateral, constituted a valuable consideration and petitioners are purchasers of said bonds for value.

Pollard v. Tobin, 211 Wis. 405.

2. Under the Negotiable Instruments Law and the rule in the Federal Courts, constructive notice of a defense to, defect in title to, or infirmity in a negotiable

instrument is not sufficient to defeat the rights of the holder of the instrument. There must be either actual knowledge thereof or knowledge of such facts that the holder's action in taking the instrument amounted to bad faith.

Pollard v. Tobin, 211 Wis. 405.

Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 1, 8.

Hotchkiss v. National Shoe & Leather Bank, 21 Wall. 354, 359.

Swift v. Smith, 102 U.S. 442, 444.

Crittenden v. Widrevitz, 272 Fed. 871.

Washington & Canonsburg R. Co. v. Murray, 211 Fed. 440, 447.

The rule which one time prevailed in some jurisdictions that, although the holder of a negotiable instrument had paid value therefor, if anything appeared upon the face of the instrument or from the facts and circumstances attending its transfer, which would put one of ordinary prudence upon inquiry that would lead to actual knowledge of the equities or infirmities, he was bound to pursue such inquiry and was charged with notice of the facts he might have learned, no longer constitutes the law; such was the rule of constructive notice. The rule of constructive notice has never prevailed in the federal courts, and has been expressly abrogated by the Uniform Negotiable Instruments Law. A brief history of the rule as to constructive notice is found in the case of *Nickey Bros. v. Lonsdale Mfg. Co.,* 149 Tenn. 1. It is now the rule that a purchaser of a negotiable instrument for value before maturity holds good title to the instrument, unless he had actual knowledge of a defect in the title of the holder, or of facts which make his taking

thereof amount to bad faith. In *Crittenden v. Widrevitz*, 272 Fed. 871, 873, the Circuit Court of Appeals for the Second Circuit states this rule in the following language:

> "Proofs, and not merely suspicious facts, are required in order to impeach the title of the holder of negotiable paper acquired for value and before maturity. *Goodman v. Simonds*, 20 How. 343, 15 L.Ed. 934. One who purchases such paper from another, who is apparently the owner, giving a consideration for it, obtains a good title, though he may know facts and circumstances that cause him to suspect, or would cause one of ordinary prudence to suspect, that the person from whom he obtained it had no interest in it, or authority to use it for his own benefit, and though by ordinary diligence he could have ascertained those facts, he can lose his right only by actual notice or bad faith."

Hotchkiss v. National Shoe & Leather Bank, 21 Wall. 354, 359.

Swift v. Smith, 102 U.S. 442, 444.

Washington & Canonsburg R. Co. v. Murray, 211 Fed. 440, 447.

The foregoing rule is embodied in Section 116.61, Wisconsin Statutes of 1929, which is hereinbefore quoted.

3. The burden of proof was upon respondent to establish knowledge on the part of petitioners of an alleged defect in title.

Hotchkiss v. National Shoe & Leather Bank, 21 Wall. 354.

Young v. Lowry, 192 Fed. 825.

King v. Doane, 193 U.S. 166, 173.

Washington & Canonsburg R. Co. v. Murray, 211 Fed. 440.

Crittenden v. Widrevitz, 272 Fed. 871.
Prigden v. Baugh & Sons Co., 30 F. (2d) 353, 355.

Under the rule in the federal courts, a person taking a negotiable instrument for value before maturity is presumed to be a holder in due course, and the ultimate burden of proof is on the person attacking the title of such holder to establish both the defect in title and the holder's knowledge thereof.

When it appears that the holder has paid value for a negotiable instrument before maturity, it is presumed that he took the same without knowledge of any defect in the title thereto. The burden of proof that he had knowledge of a defect in title, if any, is upon the assailant. In *Hotchkiss v. National Shoe & Leather Bank,* 21 Wall. 354, 359, the rule is stated as follows:

> "The law is well settled that a party who takes negotiable paper before due for a valuable consideration, without knowledge of any defect of title, in good faith, can hold it against all the world. A suspicion that there is a defect of title in the holder, or a knowledge of circumstances that might excite such suspicion in the mind of a cautious person, or even gross negligence at the time, will not defeat the title of the purchaser. That result can be produced only by bad faith, which implies guilty knowledge or wilful ignorance, and the burden of proof lies on the assailant of the title. It was so expressly held by this court in *Murray v. Lardner,* 2 Wall., 110, 17 L.Ed., 857, where Mr. Justice Swayne examined the leading authorities on the subject and gave the conclusion we have stated."

In *King v. Doane,* 139 U.S. 166, 173, the court said:

> "Whether he did or did not give value, without such notice, is the vital question in the case. And

that question must be considered with reference to the established rule that, if in an action by an indorsee against the maker a negotiable note is shown to have been obtained by fraud, the presumption, arising merely from the possession of the instrument, that the holder in good faith paid value is so far overcome that he cannot have judgment unless it appears affirmatively from all the evidence, whether produced by the one side or the other, that he, in fact, purchased for value. *Smith v. Sac County,* 78 U.S. 11 Wall. 139, 148; *Marion County Comrs. v. Clark,* 94 U.S. 278, 285; *Stewart v. Lansing,* 104 U.S. 505, 509; *Pana v. Bowler,* 107 U.S. 529, 542. In the case supposed he must show that he paid value. That fact being established, he will be entitled to recover, unless it is proved that he purchased with actual notice of defect in the title, or in bad faith, implying guilty knowledge or wilful ignorance. * * * "

Young v. Lowry, 192 Fed. 825.

Crittenden v. Widrevitz, 272 Fed. 871.

Prigden v. Baugh & Sons Co., 30 F. (2d) 353, 355.

Washington & Canonsburg R. Co. v. Murray, 211 Fed. 440, 447.

4. Petitioners took said bonds in good faith.

Cheever v. Pittsburgh S. & L. E. R. Co., 150 N.Y. 59.

Swift v. Smith, 102 U.S. 442, 444.

Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 1, 8.

Hotchkiss v. National Shoe & Leather Bank, 21 Wall. 354.

Crittenden v. Widrevitz, 272 Fed. 871.

Pollard v. Tobin, 211 Wis. 405.

Merchants National Bank v. Detroit Trust Co., 258 Mich. 526.

Mendelson v. Realty Mortgage Corporation, 257 Mich. 442.

In speaking of what constitutes bad faith, the court in *Cheever v. Pittsburgh S. & L. E. R. Co.*, 150 N.Y. 59, 65, used the following language:

> "There is not much difficulty in stating the rule of law defining the duties and obligations of a party to whom negotiable paper is presented for discount or sale before due. He is not bound, at his peril, to be on the alert for circumstances which might possibly excite the suspicion of wary vigilance. He does not owe to the party who puts the paper afloat the duty of active inquiry, in order to avert the imputation of bad faith. The rights of the holder are to be determined by the simple test of honesty and good faith, and not by a speculative issue as to his diligence or negligence. The holder's right cannot be defeated without proof of actual notice of the defect in title, or bad faith on his part, evidenced by circumstances. Though he may have been negligent in taking the paper, and omitted precautions which a prudent man would have taken, nevertheless, unless he acted *mala fide*, his title, according to settled doctrine, will prevail."

The test is whether the holder purchased honestly. It must be shown that he did not so purchase.

Swift v. Smith, 102 U.S. 442.

Hotchkiss v. National Shoe & Leather Bank, 21 Wall. 354, 359.

Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 1, 8.

Crittenden v. Widrevitz, 272 Fed. 871.

Merchants National Bank v. Detroit Trust Co., 258 Mich. 526.

Pollard v. Tobin, 211 Wis. 405.

It is undisputed that petitioners paid adequate consideration for said bonds (R. 29-32). Such consideration constitutes *prima facie* evidence of good faith.

Pollard v. Tobin, 211 Wis. 405.

At most, petitioners can only be charged with knowledge of facts that appeared upon the face of said bonds. Such facts consist of the references to the trust deed and that Hackett, Hoff & Thiermann, Inc., was trustee of the trust deed securing payment of said bonds (R. 66, 67).

References such as this in a bond to a trust deed have been construed by the courts to refer solely to the security and the rights in and to the same. If such is the construction of such references by a court, petitioners can, at most, only be charged with knowledge of the references so construed. A different or wider construction thereof cannot be imposed upon petitioners. Such references meant to petitioners what they did to the Court of Appeals of New York, as stated in *Enoch v. Brandon,* 249 N.Y. 263. Said bonds merely refer petitioners to the security for the payment of said bonds, and petitioners might go to the deed of trust, if they saw fit, to ascertain the nature of their security, their rights in such security as the holder of one of said bonds and the nature of their lien as a bondholder. Nothing on the face of the bonds suggests or intimates in any way that any of said Kalt-Zimmers Manufacturing Company bonds, secured by said trust deed, were held by Hackett, Hoff & Thiermann, Inc., in a fiduciary capacity, or that the transfer thereof was in any way restricted.

Said bonds and the trust deed constitute separate and distinct contracts.

Mendelson v. Realty Mortgage Corporation, 257 Mich. 442.

Paepcke v. Paine, 253 Mich. 636.

The fact that it appeared that Hackett, Hoff & Thiermann, Inc., was the holder as trustee of the property to secure the payment of all of said bonds did not constitute notice or carry any intimation that said bonds were held in trust or in any fiduciary capacity. Said bonds are payable to bearer. Hackett, Hoff & Thiermann, Inc., as such bearer presented said bonds to petitioners and received as loans thereon practically the face value of the bonds (R. 29-32). These facts do not even tend to establish that petitioners took said bonds in bad faith, or that they did not acquire them honestly.

In *Montvale v. Peoples Bank,* 74 N.J.L. 464, the Mayor of the City of Montvale executed certain improvement bonds on behalf of the city. He retained such bonds in his possession as Mayor. Some of such bonds he subsequently hypothecated to the bank to secure his individual loan. It was held that the bonds involved were negotiable instruments and that the bank was a holder in due course. In reference to the contention that the bank should be charged with notice of the pledgor's defect in title because it appeared upon the face of the bonds that he had executed them as Mayor, the court said that he had as complete a right as any other citizen or member of the public to become a purchaser of the city's securities, and the fact that he assumed to deal with them as his own in the transaction with the bank, instead of being notice to it that he was betraying the trust imposed upon him, justified the bank in believing

that he was in fact just what he represented himself to be by his conduct, namely, the owner of the securities. Even though petitioners had examined the trust deed, they would have found that Hackett, Hoff & Thiermann, Inc., had the right to acquire, hold and deal in the bonds and coupons with the same right as if not trustee under the trust deed (R. 37).

Petitioners submit that the case of *Nickey Bros. v. Lonsdale Mfg. Co.,* 149 Tenn. 1, is directly in point.

It is, therefore, submitted that petitioners took said bonds for value, before maturity, in good faith, without knowledge of any defect in the title thereto, and that they are the holders thereof in due course.

CONCLUSION

The decision of the Circuit Court of Appeals should be reversed and the order of the Referee in Bankruptcy affirmed.

Respectfully submitted,

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